

2.4 Fiscal policy: The government budget

Learning Outcomes

- Explain that the government earns revenue primarily from taxes (direct and indirect), as well as from the sale of goods and services and the sale of state-owned (government-owned) enterprises.
- Explain that government spending can be classified into current expenditures, capital expenditures, and transfer payments, providing examples of each.
- Distinguish between a budget deficit, a budget surplus, and a balanced budget.
- Explain the relationship between budget deficits/surpluses and the public (government) debt.

Distinguish between a budget deficit, a budget surplus, and a balanced budget, and explain how the budgetary position affects government debt

The government budget is a forecast of the amount of government expenditure and government revenue for the coming year.

Model sentence: A budget surplus occurs if government revenue is greater than government expenditure. A budget deficit occurs if government expenditure is greater than government revenue, and a balanced budget occurs if government expenditure equals government revenue.

Subject vocabulary

financial institution a business, such as a bank, that provides a service allowing firms and households to make deposits and take out loans and to make investments

interest payments the money paid at regular intervals on loans

direct taxes a tax that is paid directly by an individual or firm to the government. For example income tax on wages and company profits.

state-owned enterprise a business that is partially or fully owned by a government

share a unit of ownership of a company's capital. The owner is entitled to a proportion of the company's profit.

capital (goods) manufactured goods that are used in the production of other goods

Glossary

infrastructure the basic structure/systems of a country (e.g. roads/railways)

When a deficit is expected the government must make arrangements to borrow money from **financial institutions** and the public to make up the difference between expenditure and revenue. Many countries have a budget deficit. Borrowed money contributes to government revenue. Government debt, often called the national debt, is the total amount of money that the government has borrowed over the years that has not been paid back. When a government expects a budget surplus, it can plan to pay back to the lenders some of the national debt. When the government expects a budget deficit, it must plan to borrow more money, thereby adding to the national debt.

Model sentence: When a government continues to run a budget deficit year after year the national debt and the **interest payments** on the debt will continue to rise.

What are the main sources of government revenue and the different types of government expenditure?

Government borrowing means that government expenditure can exceed revenue. The largest contribution to government revenue comes from **direct taxes** and indirect taxes. Another source of revenue comes from the sale by the government of state-owned businesses. For example, in 2013 the UK government sold Royal Mail, a **state-owned enterprise**, the main business of which was the delivery of residential and business letters and parcels. The government sold **shares** in Royal Mail to the public and to financial institutions. The shareholders then became the new owners. The money raised from the sale of the shares, in excess of £2 billion, went to the government, increasing government revenue. When a state-owned business makes a profit it is a source of revenue for the government while any loss is subsidized by the taxpayer. Since the privatization of Royal Mail, the profit goes to the shareholders who are now the owners of the business.

Total government expenditure is the sum of current expenditures, capital expenditures, and transfer payments. Transfer payments include state pensions and welfare payments such as unemployment benefits.

Current expenditure is spending on goods and services that only last a relatively short period of time and, therefore, it is expenditure that takes place continuously. They are goods that are used up quickly in the provision of a service: for example, medicines in the health service. The wages paid to people who work for the state are also part of current expenditure. For example, the wages of doctors and nurses, soldiers, and teachers are part of current expenditure. Capital expenditure is spending on durable **capital** goods: goods that last a long time. They are goods that can be used again and again, but that at some point will need repairing or replacing. Capital expenditure is spending on **infrastructure** such as new schools, hospitals, roads, and capital equipment such as computers.

Model sentence: Capital expenditure has lasting positive effects on the economy. It increases productivity and GDP whereas current expenditure has only short-term benefits.

Test your understanding of this unit by answering the following questions

- Explain the relationship between total government debt and the budgetary position.
- Distinguish between government current expenditure and capital expenditure.

Subject vocabulary

productivity the quantity of output per unit of input

GDP gross domestic product is the monetary value of all the finished goods and services produced within a country in a given period of time, usually measured over a year

Learning Outcomes

- Explain how changes in the level of government expenditure and/or taxes can influence the level of aggregate demand in an economy.
- Explain the mechanism through which expansionary fiscal policy can help an economy close a deflationary (recessionary) gap.
- Construct a diagram to show the potential effects of expansionary fiscal policy, outlining the importance of the shape of the aggregate supply curve.
- Explain the mechanism through which contractionary fiscal policy can help an economy close an inflationary gap.
- Construct a diagram to show the potential effects of contractionary fiscal policy, outlining the importance of the shape of the aggregate supply curve.

Explain the relationship between fiscal policy and aggregate demand

Fiscal policy relates to the use of taxation and government expenditure to achieve macroeconomic objectives. Aggregate demand is the sum of all expenditure in the economy in a given period of time. Aggregate demand = household consumption of domestically produced goods + private sector investment + government expenditure + (export revenue – import revenue): $AD = C + I + G + (X - M)$.

Model sentence: *Ceteris paribus*, a change in government expenditure leads to a change in AD and a shift in the AD curve.

Model sentence: *Ceteris paribus*, a change in the rate of income tax changes the amount of disposable income received by households, leading to a change in household expenditure and a shift in the AD curve.

A change in corporation tax changes the amount of **retained profit** received by firms. This affects the amount of investment leading to a shift in the AD curve. **Foreign direct investment** (FDI) is affected by changes in corporation tax. As corporation tax changes, it changes the level of **inward investment**, thereby affecting AD.

Model sentence: *Ceteris paribus*, reducing taxes and/or increasing government expenditure increases aggregate demand, and increasing taxes and/or reducing government expenditure reduces aggregate demand.

Reducing taxes and increasing government expenditure may lead to increases in the **budget deficit** thereby increasing the national debt. The debt and the interest payments on the debt have to be paid by the taxpayers. Therefore, taxes have to be relatively higher in the future leaving households with less disposable income to spend. Government borrowing can lead to lower AD in the future.

Model sentence: Expansionary fiscal policy increases aggregate demand and contractionary fiscal policy reduces aggregate demand.

Using diagrams, explain how fiscal policy can affect the deflationary/inflationary gap

When the economy enters a **recession** aggregate demand and output is falling, as shown in Figure 61.1 (on page 176) by a shift of the AD curve from AD_1 to AD_2 and a fall from the full-employment level of output Y_f to Y_1 . The deflationary gap or the **recessionary gap** is the difference between Y_f and the actual level of output, Y_1 . Aggregate demand is not high enough to buy all the goods and services that can be produced

Subject vocabulary

retained profit after-tax profit that is not paid out to shareholders but is kept by the firm to be reinvested in the business or used to pay back debt

foreign direct investment cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

inward investment the purchase of assets in a country by individuals or firms from outside the country

budget deficit occurs when government expenditure is greater than tax revenue

expansionary fiscal policy policy involving the increase of government spending and/or the reduction of taxation

contractionary fiscal policy policy involving the reduction of government spending and/or the increase of taxation

recession two consecutive quarters of negative economic growth

recessionary gap occurs when real GDP is lower than full employment levels of GDP

Subject vocabulary

demand-pull inflation occurs when aggregate demand is greater than aggregate supply

long-run macroeconomic equilibrium occurs when total expenditure is sufficient to buy the potential output in a given period of time. It is represented by the intersection of the AD and LRAS curves.

aggregate supply the total supply of goods and services produced in an economy at a given price level in a given time period

cost-push inflation inflation caused by an increase in the costs of production, resulting in a decrease in aggregate supply

unemployment occurs when there are people actively looking for work at the equilibrium wage rate but are not able to find work

inflation an increase in the general level of prices of goods/services in an economy over a given time period, usually a year

spare capacity a situation when some factors of production are unemployed

costs of production the amount the firm pays for the factors of production used to produce goods or services

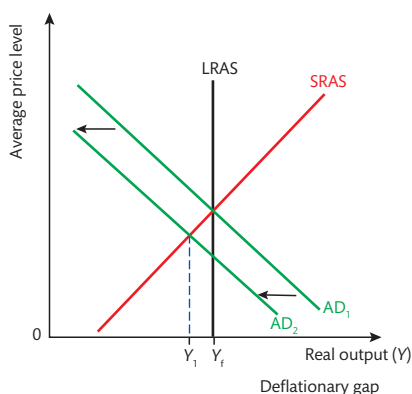


Figure 61.1

At first the economy is in **long-run macroeconomic equilibrium** at the full employment level of output Y_f . At the present level of AD there are no pressures on the price level to change. However, an increase in

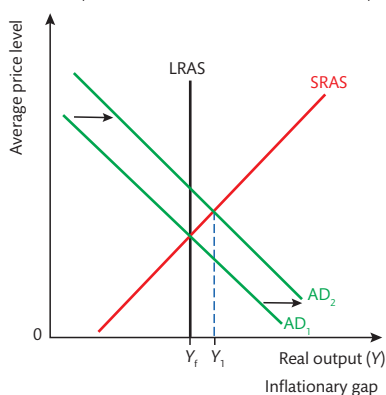


Figure 61.2

when all factors are being used. As AD falls, demand-deficient unemployment rises. The government can use expansionary fiscal policy in order to increase aggregate demand so that it is high enough to buy all goods and services produced at Y_f . Reducing taxes and/or increasing government expenditure increases aggregate demand and the AD curve shifts back to the right from AD_2 to AD_1 and firms increase output in response to higher levels of expenditure thereby closing the deflationary gap and reducing unemployment. However, increasing levels of aggregate demand causes **demand-pull inflation** and the price level increases.

aggregate demand, from AD_1 to AD_2 opens up an inflationary gap where actual output, Y_1 , is greater than the full-employment level of output, Y_f . Aggregate demand exceeds **aggregate supply**, pulling the price level up. This is called demand-pull inflation, which can lead to **cost-push inflation** as factor prices start to rise. Low and stable inflation is a government objective so the government may use contractionary fiscal policy of higher taxes and lower expenditure in order to reduce aggregate demand and output, shifting the AD curve back down and to the left from AD_2 to AD_1 until the economy is in long-run macroeconomic equilibrium.

Explain the significance of the shape of the short-run aggregate supply curve on the effects of fiscal policy

The effect on the change in output, **unemployment**, and **inflation** of fiscal policy depends on the size of the change in taxation and government spending and the slope of the SRAS curve. The size of the change in tax and government spending affects the size of the shift of AD and therefore its effect on the price level and output as shown in Figures 61.3 and 61.4. The significance of the slope of the SRAS can also be seen in the diagrams.

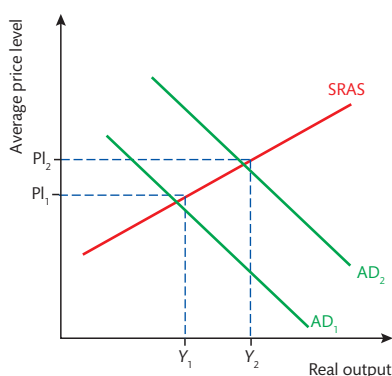


Figure 61.3

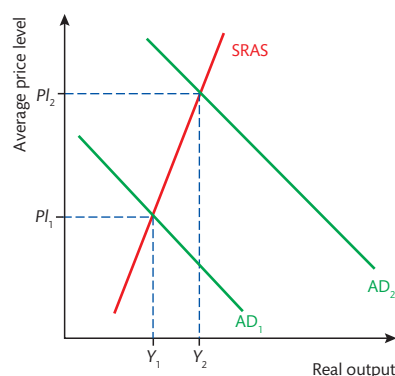


Figure 61.4

The SRAS curve is relatively shallower at lower levels of AD and output. There is lots of **spare capacity** in the economy. Unemployment of factors is relatively high. Demand for factors is low. As aggregate demand increases from AD_1 to AD_2 , as shown in Figure 61.3, firms respond by increasing output from Y_1 to Y_2 . Demand for factors increases but because supply of factors is high and demand still relatively low, factor prices rise only by a small amount leading to a relatively small increase in **costs of production**. Therefore, there is only a

small increase in the price level. Also there is a relatively large deflationary gap so increases in AD do not cause demand-pull inflation. As there is lots of spare capacity and there are lots of factors available, firms are easily able to increase output in response to an increase in aggregate demand; therefore, there is a relatively large increase in output.

The SRAS curve is steeper in Figure 61.4 than in Figure 61.3. The deflationary gap is not as big. As there are fewer factors of production available and firms have very little spare capacity, firms are only able to increase supply by a relatively small amount in response to an increase in AD.

Model sentence: The effect on output and price level from a change in AD depends on the slope of the SRAS curve. The shallower the slope, the greater the change in output and the smaller the change in the price level.

Test your understanding of this unit by answering the following questions

- Using a diagram, explain how fiscal policy can be used to reduce the recessionary gap.
- Explain how the shape of the SRAS curve can affect changes in output and the price level caused by changes in AD.

Glossary

fluctuation(s) frequent change(s) especially from a high to a low level and back again

Learning Outcomes

- Explain how factors including the progressive tax system and unemployment benefits, which are influenced by the level of economic activity and national income, automatically help stabilize short-term **fluctuations**.
- Evaluate the view that fiscal policy can be used to promote long-term economic growth (increases in potential output) indirectly by creating an economic environment that is favourable to private investment, and directly through government spending on physical capital goods and human capital formation, as well as provision of incentives for firms to invest.
- Evaluate the effectiveness of fiscal policy through consideration of factors including the ability to target sectors of the economy, the direct impact on aggregate demand, the effectiveness of promoting economic activity in a recession, time lags, political constraints, crowding out, and the inability to deal with supply-side causes of instability.

Explain the term 'automatic stabilizer'

As the economy moves through the business cycle from **recession** to **boom** and back to recession, the amount of **tax revenue** the government receives and the amount the government spends changes automatically. When the economy is booming, there is lots of economic activity. Aggregate demand is high and the economy is producing at full potential levels of output so there are very low levels of unemployment. High levels of AD can lead to demand-pull inflation and cost-push inflation. Tax revenue from **direct taxes**, which are taxes on income, are high because employment is high and tax revenue from **corporation tax** is high because company profits are high. As the economy grows, incomes rise. In a **progressive tax system** the percentage rate of tax paid on extra income earned rises, thereby further increasing the amount of tax revenue. Tax revenue from indirect taxes, which are taxes on consumption, is high because household expenditure is high. When the economy is producing at the full-potential level of output, unemployment is low. Government expenditure on welfare benefits, such as unemployment benefit, is therefore relatively low. With higher taxes and lower government expenditure, the amount of money in the economy is reduced, thereby reducing aggregate demand.

Model sentence: As the economy continues to grow, government expenditure falls and tax revenue rises, thereby 'automatically' reducing aggregate demand, the rate of growth and inflationary pressures.

In this case the rate of economic growth is reduced by the 'automatic stabilizer' and not by government contractionary fiscal policy.

In a recession, **economic growth** is negative. GDP is falling. Aggregate demand falls to a low level and firms respond by reducing the size of their workforce. Incomes fall, therefore direct tax revenue falls. Corporation tax revenue falls as company profits fall. Indirect tax revenue falls as expenditure on goods and services fall. At the same time, government expenditure on unemployment benefits increases. With lower taxes and higher government expenditure, the amount of money in the economy is increased, thereby increasing aggregate

Subject vocabulary

recession two consecutive quarters of negative economic growth

boom a period of time during which an economy experiences sustained high levels of consumption and output often leading to increases in wages and inflation

tax revenue the income government receives through the levying and collection of taxes

direct taxes a tax that is paid directly by an individual or firm to the government. For example income tax on wages and company profits.

corporation tax a tax levied in the UK on company profits

progressive tax system a system of taxation in which the rate of tax increases with income

economic growth an increase in real GDP

Subject vocabulary

expansionary fiscal policy policy involving the increase of government spending and/or the reduction of taxation

induced investment investment by firms that is caused by increases in consumption. As aggregate demand increases, and is forecast to continue to rise, firms need to increase the quantity of capital in order to meet future levels of demand.

technologically advanced capital capital that incorporates new technology and is used in place of existing capital to produce goods and services thereby increasing productivity

investment the addition to capital stock

foreign direct investment cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

value of human capital a measure of the quantity and quality of the skills of the labour force that can be employed to produce goods and services. An increase in the value of human capital leads to an increase in labour productivity.

labour productivity the quantity of goods that a worker produces in a given period of time

fiscal policy government policy designed to achieve macroeconomic objectives through government expenditure and taxation

sustainable economic growth economic growth that meets the needs and wants of the current generation in such a way that does not prevent future generations from meeting their needs and wants

market failure when resources are not allocated or used efficiently

externalities consequences of production or consumption that affect third parties

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Synonyms

equitable fair/equal

demand. The rate at which real output falls is reduced not by **expansionary fiscal policy** but by the 'automatic stabilizer'.

Explain how fiscal policy can promote long-run economic growth

As taxation falls as part of expansionary fiscal policy, households' disposable income increases, leading to an increase in expenditure. As AD increases, firms respond by increasing output. If firms expect demand to continue to increase they must invest in capital in order to be able to supply the higher future levels of demand. This is called **induced investment**. When firms buy more capital, they are likely to buy more **technologically advanced capital**. Higher levels of AD lead to an increase in **investment**, thereby increasing the quantity and quality (productivity) of capital in the economy. Full-employment level of output increases. To encourage growth, the government can cut corporation tax leaving firms with more profit to invest. Again the quantity and quality of capital in the economy rises leading to an increase in potential output. Lower corporation tax also encourages **foreign direct investment**. If foreign firms are allowed to keep more of their profits, they are more likely to set up business in the country. Increases in FDI increase the quantity and quality of capital in the economy, thereby increasing potential output. Lower tax rates encourage entrepreneurial activity, thereby increasing the number of small businesses in the economy. This contributes to increases in potential output.

As firms increase output, they employ more workers and buy new capital; therefore, more workers receive training and the **value of human capital** rises, increasing **labour productivity** contributing to increases in long-run economic growth.

Model sentence: Lower taxes lead to an increase in aggregate demand, causing an increase in induced investment and an increase in the quantity and quality of capital.

Infrastructure is the stock of fixed physical capital in an economy including roads, railways, airports, seaports, factories, communication networks, schools, and hospitals. The government in most countries provides much of the infrastructure directly through government expenditure or indirectly by setting policies that encourage private investment. Infrastructure contributes to potential output. With more factories it is possible to produce more goods; with more roads, railways, and airports, more goods and people can be transported more quickly and efficiently. With more schools and colleges of further education, it is possible to educate and train more workers thereby increasing the productivity of labour. Government spending on infrastructure is called government capital expenditure.

Model sentence: Increases in government capital expenditure on infrastructure increases the quantity and quality of physical and human capital leading to an increase in the full-employment level of output.

To show long-run economic growth on an AD/AS diagram, the long-run aggregate supply curve shifts to the right and on a production possibility diagram, the PPC moves outwards.

Evaluate the effectiveness of fiscal policy

Fiscal policy is used by government to achieve objectives. The main objective is to improve macroeconomic performance and the aims are to have low and stable inflation, low unemployment and **sustainable economic growth**. Fiscal policy is also used to achieve a more equal and **equitable** distribution of income and to correct **market failure** caused by **externalities** in production and consumption in the goods market, and market failure caused by **occupational immobility** and **geographical immobility** in the **labour market**. Set out below are ways fiscal policy can be evaluated.

Explain how government borrowing 'crowds out' private sector investment

One way to evaluate the effectiveness of fiscal policy is to examine the idea of 'crowding out'. An expansionary fiscal policy of low taxation and high government expenditure introduced to increase economic activity and reduce unemployment leads to an increase in the **budget deficit** and therefore an increase in government borrowing. In order to raise the money, the government sells **government bonds** to the public and **financial institutions**. The government has to compete with other borrowers for the limited supply of money available for lending (the supply of loanable funds). To encourage financial institutions and the public to lend to the government rather than to firms in the **private sector**, the government increases **interest rates** on the bonds. The public and financial institutions take some of their money out of the banks in order to buy government bonds, thereby reducing the amount of money banks have to lend to the private sector. Banks also lend more to the government, attracted by the higher rates of interest; therefore, the banks have less money to lend to

firms in the private sector. Increases in government borrowing lead to a fall in the supply of loanable funds available for the private sector.

Model sentence: Government borrowing to fund the budget deficit ‘crowds out’ private sector borrowing and pushes up interest rates, leading to a fall in investment by firms in the economy.

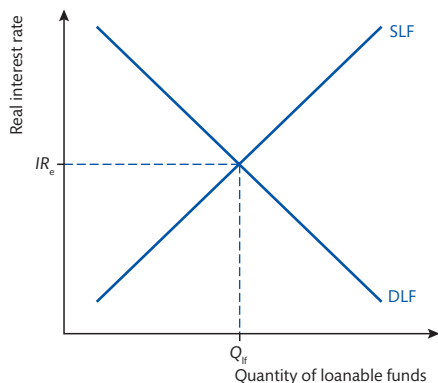


Figure 62.1

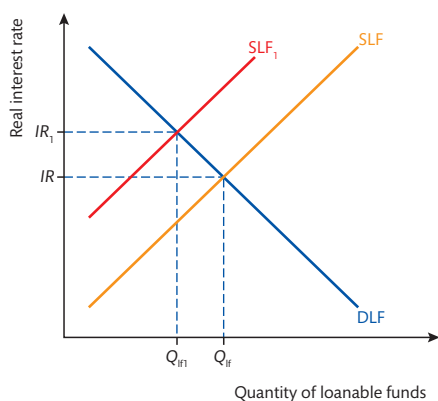


Figure 62.2

Increased government expenditure does increase aggregate demand but to increase expenditure the government must borrow. This pushes up interest rates. Higher interest rates means that households increase the amount of income they save, thereby reducing household expenditure and aggregate demand. Higher interest rates also reduce investment by firms leading to a further fall in aggregate demand. This negative effect on aggregate demand may mean that the government might not achieve its macroeconomic objectives.

Explain why fiscal policy may lead to some macroeconomic objectives not being achieved

Another possible negative effect on AD of expansionary fiscal policy comes from higher levels of expenditure. The government reduces taxation and increases government spending in order to increase aggregate demand and economic growth and to reduce unemployment. If the economy grows too quickly, it can lead to demand-pull and cost-push inflation. If this happens the government might use contractionary fiscal policy to reduce aggregate demand in order to reduce inflation. However, this policy might put the economy back into recession. The government now has to reduce taxes and increase government expenditure in order to encourage economic growth. Economists call this the ‘stop-go cycle’ because fiscal policy is used to stop the economy growing and then the policy must be changed in order to get the economy going again.

How might expansionary fiscal policy affect the demand for imports and exports?

Higher interest rates brought about by increases in government borrowing will attract foreign investors looking for better returns on their savings. If, for example, demand for UK government bonds increases because of the

The supply of loanable funds curve (SLF) in Figure 62.1 shows the amount of savings in the economy available for lending at each interest rate. As interest rates rise, the incentive to save increases therefore the quantity supplied of loanable funds rises. The demand for loanable funds curve (DLF) shows the demand for loanable funds at each rate of interest. As interest rate rises, the cost of borrowing increases, therefore the quantity demanded of loanable funds falls. The equilibrium interest rate, IR , is the rate at which quantity supplied of loanable funds is equal to the quantity demanded.

When the government borrows more money, the supply of loanable funds available for the private sector falls and the supply of loanable funds curve shifts up and to the left from SLF to SLF_1 . At the original rate of interest, IR , quantity demanded of funds is greater than quantity supplied. In order to remove the excess demand the interest rate rises. As it rises, quantity demanded falls and quantity supplied increases until the new equilibrium IR_1 and Q_{if1} is reached. The effect of government borrowing is to increase interest rates on private sector borrowing, thereby reducing the quantity of private sector investment.

Subject vocabulary

continued from page 178

occupational immobility occurs when workers do not have the necessary skills to change jobs

geographically immobile describes workers who are unable to relocate in order to find work, often because of the high costs of moving

labour market a market in which firms demand labour and workers supply labour. The interaction of demand and supply of labour determines the equilibrium wage.

budget deficit occurs when government expenditure is greater than tax revenue

government bonds issued by government to investors in exchange for lending it money. The investor is entitled to interest payments on the loan as well as repayment of the loan when the bond matures.

financial institution a business, such as a bank, that provides a service allowing firms and households to make deposits and take out loans and to make investments

private sector the part of the economy that is regulated but not controlled by the state and concerns individuals and groups bringing together the factors of production normally with the aim of making a profit

interest rate the percentage amount charged by a lender for money borrowed

Subject vocabulary

foreign exchange market a decentralized global market for the buying and selling of currencies

current account deficit occurs when the amount of money flowing out of a country from the trade in goods and services, investment income, and transfers is greater than the amount flowing in

exchange rate the price of a country's currency in terms of another currency

marginal propensity to import the proportion of additional income that an individual spends on imported goods and services. $MPM = \frac{\text{the change in expenditure on imports}}{\text{the change in income}}$

demand-deficient unemployment

unemployment caused by a lack of aggregate demand. Unemployment changes as the economy goes through the business cycle, increasing when AD falls and decreasing when AD rises.

structural unemployment unemployment caused by a change in the type of labour firms demand. It is caused by a mismatch of the skills of those unemployed and the skills needed by firms.

natural rate of unemployment the rate of unemployment at which inflation stabilizes. At the natural rate of unemployment, all who want to work at the market wage can find work therefore there is no involuntary unemployment.

external supply-side shock occurs when there is an unexpected change in the supply of a good produced abroad that results in a sudden change in its price

productivity the quantity of output per unit of input

Glossary

infrastructure the basic structure/systems of a country (e.g. roads/railways)

time lag(s) period(s) of time between two linked events

higher interest rate on UK bonds, foreigners who want to buy bonds must buy £s with their currency which they then use to buy the bonds. The demand for the £ increases on the **foreign exchange market**, pushing up the value of the £. As the £ goes up in value against other currencies, the price foreigners have to pay for UK exports goes up and the price UK consumers pay for imports falls, leading to a fall in consumption of exports and an increase in consumption of imports. Net exports ($X - M$) falls causing a fall in AD and an increase in the **current account deficit**. The size of the increase in aggregate demand brought about by expansionary policy might therefore not be as big as the government wanted.

When AD increases and incomes rise, households buy more goods including more imports. The quantity of extra imports that households buy depends on the **marginal propensity to import**. If the demand for imports rises at a greater rate than demand for exports, net exports falls leading to a fall in AD and an increase in the current account deficit.

Explain the effect time lags have on the success of fiscal policy decisions

The statistics on inflation, unemployment, and economic growth take a long time to research and gather. By the time policymakers have the information, it will be out of date. The statistics gathered may also be unreliable. Therefore, the decision to increase or decrease aggregate demand by changing fiscal policy may be the wrong decision and therefore will not help to achieve the macroeconomic objectives and may even make the situation worse.

It takes time for households to react to changes in policy. Households will not immediately increase expenditure when taxes are cut. It can take months before households change their patterns of consumption, therefore, aggregate demand will not be affected immediately. However, tax cuts are likely to affect aggregate demand more quickly than increases in capital expenditure. Government investment in **infrastructure** will take a long time to affect economic activity. Government decisions to build a new railway or new roads cannot be made quickly and it will be years before building starts and for the money to be injected into the circular flow of income. The long **time lags** and the possible inaccuracy of the national statistics means that using fiscal policy to achieve macroeconomic objectives may not work.

Why might political considerations affect fiscal policy?

Politicians decide on fiscal policy. Politicians and political parties want to be re-elected at the next election. Tax cuts are popular with the people. Politicians may decide to cut taxes and increase benefit payments before an election to gain votes even if the economy is near to full-employment level of output. An expansionary fiscal policy at this time may increase the chances of the political party being re-elected but would cause high levels of inflation in the months after the election. If aggregate demand is high and there are dangers of demand-pull and cost-push inflation, the government should increase taxes to reduce aggregate demand. However, if this occurred near an election the government may not cut taxes for fear of losing votes.

Are unemployment and inflation always caused by demand-side factors?

Demand-deficient unemployment can be reduced by increasing aggregate demand through expansionary fiscal policy. However, **structural unemployment** needs supply-side solutions. Fiscal policy will not directly affect levels of structural unemployment. If a government tried to reduce unemployment below the **natural rate of unemployment** it might lead to inflation. Inflation is not only caused by high levels of aggregate demand. Inflation can be caused by **external supply-side shocks**. If a currency falls in value against other currencies, the price of imports, including the price of raw materials, increases leading to inflation. In these cases, inflation cannot be reduced directly by changes in fiscal policy. Poor economic performance is not always due to demand-side factors. Low levels of **productivity** due to lack of investment in physical capital and human capital over time makes firms internationally uncompetitive. If competitiveness falls demand for imports will rise and demand for exports will fall leading to lower levels of economic activity. In this case, the productivity of the factors is the cause of the problem and supply-side policies are needed to increase productivity.

Test your understanding of this unit by answering the following questions

- Explain the term 'automatic stabilizer'.
- Evaluate the use of fiscal policy to achieve government macroeconomic objectives.